

INTERNATIONAL COMMERCIAL ARBITRATION, THE BEST WAY TO RESOLVE COMMERCIAL DISPUTES? A LESSON LEARNED FROM INDONESIA PRACTICE

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Abstract

International arbitration has long been recognized as a mean of resolving commercial disputes, especially those with international dimensions. It's believed that arbitration offers some advantages compare to litigation. As a result, foreign investors have been increasingly using international arbitration provisions in their agreements.

Indonesia has enacted it's new arbitration law. However, the new law does not provide crucial mechanism on how the winning party can have their right protected. As a consequence, several international arbitral awards cannot be enforced. This paper offers some recommendations to minimize the possibility of Indonesian court's refusal to enforce international arbitral awards.

Keywords: *international commercial arbitration, award, enforcement*

A. Introduction

The crisis that hit Asia in the 1990's has changed the Asian economy dramatically. Indonesia was not excluded in this case. As a result, many national projects have been postponed by the Indonesian government. This policy has caused disputes between foreign investors and Indonesian parties.

One of the consequences of globalization is that "the individual nation-state no longer has exclusive control over the nature and content of its legal system".¹ In the light of trade and business, legal services are needed to provide a better way

to resolve any disputes that may arise in a fast and simple mechanism. Therefore, legal services have changed dramatically to fulfill the contemporary needs of the business sector.²

Arbitration may provide an answer to resolve commercial disputes. For foreign investors which operate in Asia, international arbitration is preferable to domestic arbitration. As a result, investors have increasingly used international arbitration provisions in their agreements, to provide more efficient dispute resolution for disputes that arise in their contracts.³ However, in fact interna-

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¹ Veronica Taylor, 1999, "The Transformation of Indonesian Commercial Contracts and Legal Advisers" in Timothy Lindsey (ed), *Indonesia Law and Society*, p. 280.

² *Ibid.*, p. 288.

³ Dinesh D. Banani, 2003, "International Arbitration and Project Finance in Developing Countries: Blurring the Public/Private Distinction" *Boston College International and Comparative Law Review*, p. 355.

tional arbitration does not always give a better solution.

This paper shows that international arbitration is not necessarily the best solution to resolve commercial disputes, especially disputes related to foreign investors in Indonesia. This is because international arbitration awards often cannot be enforced in Indonesia. This paper analyze in what circumstances arbitration awards cannot be enforced in Indonesia.

In the first part, this essay will explain the background as to why arbitration is a good method to resolve commercial disputes in Indonesia. This includes an explanation about the poor condition of Indonesian courts which leads to the use of arbitration. In the second part, it analyze three cases in which the Indonesian party lost in the international arbitration proceedings. This includes the reasons why the Indonesian court refused to enforce the arbitral award. The last part will give some recommendations for foreign investors to minimize the risk of unenforceable arbitration awards.

B. The Indonesian Court Condition

The Indonesian legal system has many weaknesses. The problems with the court are

complex. The judges are considered not to have a sufficient level of legal skills to resolve commercial disputes.⁴ The problem that foreign investors identify is "the role of patrimonial state, the colonial contract legacy and the lack of legal infrastructure for dispute resolution".⁵ In addition, Indonesia faces a problem with corruption in its courts.⁶ Those conditions make contracts uncertain and difficult to enforce in Indonesia. Both Indonesian and foreign parties, therefore, avoid the courts in resolving their disputes.

Most of the foreign investors in Indonesia believe that they will face difficulties in having their legal rights satisfied.⁷ This is the biggest problem faced by foreign investors in Indonesia.⁸ Therefore the need for a better procedure to resolve the commercial disputes involving foreign and Indonesian private parties is inevitable.⁹ The parties have two alternatives to the formal mechanisms of dispute resolution: litigation and arbitration. Those choices can be made right after or before the disputes arise.¹⁰

The foreign party is likely to face difficulties in pursuing litigation in Indonesia. This is regardless of whether the action was commenced in Indonesia or abroad because

⁴ David K. Linnan, 1999, "Indonesia Law Reform, or Once More unto the Breach: A Brief Institutional History" *Australian Journal of Asian Law*, p.17.

⁵ Taylor, *Op. Cit.*, p. 280.

⁶ Linnan, *Op. Cit.*, p. 15.

⁷ Stephen B. Green, 1999, "Arbitration: A Viable Alternative for Resolving Commercial Disputes in Indonesia?" in Timothy Lindsey (ed), *Indonesia Law and Society*, Davis as quoted by Stephen B Green, above n. 3, p. 292.

⁸ *Ibid.*

⁹ *Ibid.*, p. 292.

¹⁰ *Ibid.*

it cannot get its judgment enforced.¹¹ Indonesia does not recognise foreign judgment; therefore judge's decisions from other countries cannot be enforced in Indonesia.

It is believed that the Indonesian judicial system is: "ill-equipped to deal with commercial matters particularly those with International dimension." Moreover, it is "inefficient, slow and many judges lack sufficient knowledge of the law."¹² In Indonesia, people tend to appeal every court decision in order to delay payment or the execution of the court decision.¹³ Therefore, using the Indonesian court to resolve commercial disputes for foreign investors is not the best choice.

C. Arbitration in Indonesia

Due to the many problems that the Indonesian courts have, it is a wise choice for companies to resolve commercial disputes through arbitration. The parties can choose either domestic arbitration or international arbitration. Domestic arbitration is usually easier to enforce in Indonesia, but this does not always happen since there is no clear distinction between domestic and foreign arbitration awards.¹⁴

1. The Role of BANI

BANI, the Indonesian National Board of Arbitration was established in 1977, as an initiative of KADIN, the Indonesian Chamber of Commerce and Industry.¹⁵ It is an independent and autonomous body which serves to administer arbitration, both national and international, and gives binding advice regarding questions arising from a contract.¹⁶

However, the numbers of disputes that have been decided by BANI are relatively small.¹⁷ This is because the companies usually choose arbitration which takes place outside Indonesia, as recommended by their lawyers.¹⁸ Some of foreign companies question BANI's neutrality and reliability.¹⁹ Furthermore, unfamiliarity with the BANI procedure and the matter of the adequacy of its facilities are the main obstacles.²⁰

2. Party of the New York Convention, UNCITRAL and ICSID

Indonesia ratified the International Centre for Settlement of Investment Disputes (ICSID) Convention in 1968. In addition, Indonesia acceded to the New York Conven-

¹¹ *Ibid.*, p. 293.

¹² Matthew Stephens, 2003, "Local-level Dispute Resolution in Post-Reformasi Indonesia: Lessons from the Philippines" *The Australian Journal of Asian Law*, p. 213.

¹³ Green, *Op. Cit.*, p. 292.

¹⁴ Green, *Op. Cit.*, p. 295.

¹⁵ *Ibid.*, p. 297.

¹⁶ Indonesian National Arbitration Board Procedural Rules, Article 1(3).

¹⁷ Green, *Op. Cit.*, p. 298.

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ *Ibid.*, p. 299.

tion on the Recognition and Enforcement of Foreign Arbitral Awards of 1958,²¹ the most effective convention in the field of arbitration. Therefore, foreign arbitral award should be enforceable in Indonesia.²² However, in fact, foreign arbitral awards often cannot be enforced in Indonesia. In many cases, the Indonesian court has refused to enforce the awards.²³

The Indonesian Supreme Court: *Mahkamah Agung* promulgated regulation No 1 of 1990 as a set of implementing regulations for the enforcement of the international arbitration awards. This regulation gives limitations to the awards that can be enforced in Indonesia. *First*, the award must be rendered by a tribunal in a country which is a party to a bilateral or multilateral convention with Indonesia concerning the reciprocal recognition and enforcement of foreign arbitral awards;²⁴ *second*, an original must relate to a cause of action that would fall within the scope of commercial law as the term is understood in Indonesian law;²⁵ and *third*, the award must not contravene Indonesian law and public order or public policy.²⁶

However, the enactment of this regulation did not guarantee the enforceability of foreign arbitral awards. In fact, Indonesian court has a very broad discretion to deter-

mine whether or not an International award can be enforced in Indonesia. This is especially in the relation with the notion of public policy. The court evaluates whether or not the award is contrary to the Indonesia public policy.²⁷ Public policy is very important measure since it is "the fundamental principles of the legal and social system in Indonesia".²⁸

D. Cases

Generally speaking, an arbitral award is final and binding. The winning party, therefore, expect the award can be enforced immediately. However, in Indonesia, there are some cases in which the arbitration awards are not performed voluntarily by the Indonesian party.

1. Pertamina v Karaha Bodas Company

Karaha Bodas Company (KBC) is a company controlled by Florida Oower & Light and Caithness Energy of New York in partnership with the Indonesia local company. KBC entered into contract with Pertamina, Indonesian state oil and gas company and PT PLN (Persero) an Indonesian state electric utility company, relating to the development of a geothermal project in West Java, Indonesia. The contracts

²¹ Presidential Decree No. 34/1981.

²² Taylor and Pryles, *Op. Cit.*, p. 16.

²³ Taylor and Pryles, *Op. Cit.*, p. 16.

²⁴ Regulation No. 1 of 1990, Art 3(1).

²⁵ Regulation No. 1 of 1990, Art 3(2).

²⁶ Regulation No. 1 of 1990, Art 3(3).

²⁷ Green, *Op. Cit.*, p. 296.

²⁸ Gautama as quoted by Green, *Ibid.*, p. 297.

contained provisions by which any disputes that may arise will be solved through arbitration in Geneva under the UNCITRAL Arbitration Rules.²⁹

Due to the economic crisis, the Indonesian government through Presidential Decree No 47 of 1997 postponed the project as part of its agreement with the International Monetary Fund (IMF). KBC commenced an arbitration proceeding in Switzerland against Pertamina and PLN. The arbitration tribunal gave its decision in favour with KBC, holding that Pertamina and PLN had breached the contract.³⁰

The tribunal ordered Pertamina and PLN to pay US \$ 261 million in compensation to KBC, plus interest until the date of full payment.³¹ KBC filed a case in the Texas District Court seeking confirmation of the award and the court gave a decision which confirmed the award.³² The Texas court held that Pertamina's argument was not valid.³³

However, in order to prevent KBC from enforcing the award, then Pertamina filed an action in the Central Jakarta District Court against KBC. The Central Jakarta District Court issued an injunction in favour of Pertamina. The court prohibited KBC from tak-

ing any action to enforce the arbitral award. The court also held that KBC had an obligation to pay a certain amount of money that must be paid to Pertamina.³⁴ The court also declared that its judgment could be enforced immediately even though there is any appeal.³⁵

2. PLN v Himpurna and Patuha Company

The next case is other Indonesian geothermal power projects sponsored by CalEnergy Company, Inc known as the Patuha and Himpurna project and PLN. Himpurna has agreed to develop a multi-unit power project at the Dieng geothermal field on Java. PLN on the other side agreed to buy the electricity from that field.

The similar contract also dealt with Patuha in other place. Those contracts were approved on behalf of the Government of Republic Indonesia by the Minister of Mines and Energy. Moreover the Indonesia Ministry of Finance issued letters to each project company undertaking that "as long as the project company's material obligations which are due under the contract have been fulfilled, the Government will cause Pertamina and PLN to honour and

²⁹ Rona G. Shamon, and Irene M TenCate, "Absence of Consent Trumps Arbitral Economy: Consolidation of Arbitrations Under U.S. Law" (2001) 12 *The American Review of International Arbitration*, p. 358.

³⁰ *Ibid.*, p. 358-359.

³¹ Tony Budidjaja, 2002, *Public Policy as Grounds for Refusal of Recognition and Enforcement of Foreign Arbitral Awards in Indonesia*, p. 98.

³² "Pertamina to Abide by U.S Verdict in Contract Dispute" *The Jakarta Post*, 27 March 2004.

³³ "Indonesian Spat Continues", *International Oil Daily* 25 March 2004.

³⁴ Budidjaja, *Op. Cit.*, p. 99.

³⁵ *Ibid.*

perform their obligations as due in the contract".³⁶

Both parties agree to resolve any disputes by using arbitration under the UNCITRAL arbitration rules. Jakarta was chosen as the place of arbitration and the Indonesian law has been chosen as the governing law.³⁷ Moreover under Section 8.4, the parties have agreed to avoid judicial intervention.³⁸

The problem began when the economic crisis caused the exchange rate to fluctuate from 2,400 Rupiah to 16,000 Rupiah to the US Dollar in 1998. As a consequence, PLN considered its obligations to purchase power from Himpurna/Patuha could not be performed.³⁹

Himpurna and Patuha initiated arbitration proceedings against PLN and against the Indonesian government.⁴⁰ The tribunals issued awards in favour of Himpurna/Patuha. The tribunal decided that PLN had breached the contract. Accordingly, the tribunals terminated the contract and awarded damages to Himpurna of US \$ 391,711,652 and to Patuha of US \$ 180,570,322.

In these cases, the tribunals issued large awards against the Republic of Indonesia and its State-owned companies. Again, the Central Jakarta District Court refused to enforce the awards. The Indonesian local

courts appeared intent on preventing arbitral enforcement which did not favour Indonesian parties. The doctrine of anti judicial interference with international arbitration has been ignored.

3. PLN v Paiton

Another case in the independent power project is PLN v Paiton which is sponsored by Edison Mission Energy, Inc. Paiton was obliged to build the Paiton I power project. Due to the economic crisis, PLN sought reductions in the tariffs because PLN was unable to buy at the agreed price.⁴¹

The contract had an arbitration clause in it. However, PLN, filed a lawsuit with an Indonesian court. The PLN asked the court to void the power purchase agreement because on the PLN point of view the contract was void by reason of corruption.⁴² Paiton, in contrast, initiated arbitration proceedings against PLN in Stockholm. Responding this proceeding, the Central Jakarta District Court issued an injunction against the proceedings.

E. The Problem Encountered by International Arbitration Awards.

There are some obstacles regarding the enforcement of foreign arbitral awards in

³⁶ Mark Kantor, 2001, "International Project Finance and Arbitration with Public Sector Entities: When is Arbitrability a fiction?" *Fordham International Law Journal*, p. 1126-1127.

³⁷ *Ibid.*, p. 1128.

³⁸ *Ibid.*

³⁹ *Ibid.*, p. 1130.

⁴⁰ Kantor, *Op.Cit.*, p. 1130.

⁴¹ *Ibid.*, p. 1139.

⁴² *Ibid.*, p. 1140.

Indonesia. These include: the interpretation of public policy; the notion of national interest; trauma of the Dutch colonialism; and anti foreign investment movements in Indonesia.

1. Public Policy

Most countries in the world provide some reasons of annulment against arbitration awards. Public policy limitations are generally accepted in their national laws as a ground for setting aside arbitral awards.⁴³ This is in accord with the New York Convention⁴⁴ and the UNCITRAL model law,⁴⁵ in which public policy is one of the grounds for refusal of an international arbitration award.

The issue of public policy, therefore, appears at the end of the arbitral procedure when the winning party seeks enforcement.⁴⁶ Even though the use of public policy limitations is a common refusal of foreign arbitration awards, the perception of public policy differs from one country to another. What is considered as public policy in one country may not be seen as public policy in another country.⁴⁷

Indonesia has applied public policy concerns to limit arbitrations as a dispute settlement procedure.⁴⁸ In this regard, the New York Convention, in its provision, explicitly authorizes a court in an enforcing country to "refuse recognition and enforcement upon finding that 'the recognition or enforcement of the award would be contrary to public policy of that country'".⁴⁹ 'Public policy' in the NYC is public policy from the country where recognition and enforcement of an international arbitration is sought, not the public policies of the host State of the investment.⁵⁰

Using public policy arguments against an international arbitration award is the most effective way for a host country if the country refuses the award. For this reason, public policy is usually interpreted broadly by the local court. This generally happens in developing countries. Most developing countries have argued that international arbitration is biased against them.⁵¹

Developed countries generally apply the concept of public policy narrowly.⁵² The court in developed countries limits the public policy defence only if the awards "breaches

⁴³ Bockstiegel, Karl-Heinz, 1987, "Public Policy and Arbitrability" in Pieter Sanders (ed), *Comparative Arbitration Practice and Public Policy in Arbitration*, p. 188.

⁴⁴ Article V(2) b of the New York Convention.

⁴⁵ Article 34(2) b the UNCITRAL model law.

⁴⁶ Bockstiegel, *Op.Cit.*, p. 178.

⁴⁷ *Ibid.*, p. 179.

⁴⁸ Law No 30 of 1999 Article 66(c).

⁴⁹ Article V(2)b of the New York Convention.

⁵⁰ Kantor, *Op.Cit.*, p. 1169.

⁵¹ Banani, *Op.Cit.*, p. 356.

⁵² Kantor, *Op.Cit.*, p. 1169-1970.

of the forum state's most basic notions of morality and justice."⁵³ This is because the broad interpretation of public policy to protect national interest can undermine the arbitration proceeding. As far as the New York Convention is concerned, courts have to apply public policy limitation from a narrow point of view.⁵⁴

The risk that may exist is that courts in developing countries will interfere to stop the enforcement of the arbitration awards, which involve foreign investors and the government agencies of that country, especially by using economic and political turmoil, as well as corruption as part of public policy.⁵⁵ The reliability and accountability of such a decision is questionable. It is unclear whether the annulment of the awards is because of "possible corruption or political influence on the local court system or because of the absence of experience with the best political and commercial practices."⁵⁶

In the Karaha and the Paiton cases, the Indonesia parties use allegations of corruption on the project to refuse the arbitration awards. Arbitration in these projects is ineffective because there is "inherent conflict that arises in negotiating private law with government entities for matters that have

traditionally been in the realm of public law and legislatures."⁵⁷ In this regard, foreign investors view the project merely as a private matter, while the government entities view the project as public services.⁵⁸ For this reason, the state entities "may create situations in which they can encroach upon the private rights and obligations of the private sponsors in arbitration proceedings with the justification that such encroachment is necessary to maintain the sovereignty and authority of the government over important public services."⁵⁹

In the Karaha case, the Indonesian court intervened in the substance of the contract by held that the disputes involving allegations of corruption. Furthermore, the court held that the contract is not merely private but having respect to public matters because it related to national programs. A dispute related to corruption allegations, therefore, is not arbitrable in Indonesia.⁶⁰ It seems that public policy concerns, in this case, are covered not only by the public policy defense, but also by the "non-arbitrability" defense.⁶¹

The use of allegations of corruption is also evident in the Paiton case. The PLN argued that the project suffered from cor-

⁵³ *Ibid.*, p. 1169-1970.

⁵⁴ Bockstiegel, *Op. Cit.*, p. 89.

⁵⁵ Kantor, *Loc. Cit.*, p. 1172.

⁵⁶ *Ibid.*

⁵⁷ Banani, *Op. Cit.*, p. 368.

⁵⁸ *Ibid.*, p. 368.

⁵⁹ *Ibid.*, p. 369.

⁶⁰ Kantor, *Op. Cit.*, p. 1168.

⁶¹ *Ibid.*, p. 1169.

ruption, collusion, and nepotism since the project's major participant is one of the relatives of the former president Soeharto. For that reason, PLN stated that the contract is not valid since it was obtained by corrupt means. As a result, the lawsuit is filed by the PLN at an Indonesian court rather than at arbitral tribunal.

According to the doctrine of separability, the arbitration agreement is "independent of and separate from" the main contract in which the arbitration agreement exists.⁶² Therefore, when the main contract is void the arbitration agreement may still exist. In this case, when the PLN claimed that the dispute could not be heard in arbitration because the contract was void, the judge would hear that argument. Such judicial intervention is allowed "only if the arbitration clause itself were asserted to be defective and invalid, not merely because it was part of a broader allegedly invalid contract."⁶³

In case where the judge found that the arbitration agreement is valid, the judges have to ask the parties to settle the dispute through arbitration tribunal, as agreed in the contract.⁶⁴ The principle of separability is also recognized in the UNCITRAL model law in which Indonesia is one of the parties, therefore the principle of separability shall also be recognized in Indonesia.

In the Paiton case, the Indonesian court seems to ignore the doctrine of separability by holding that the dispute was unarbitrable since it involves corruption matters. The court held that the court was the proper forum to handle the Paiton case, and not the tribunal.

Since the Indonesian court has broad power to grant or refuse enforcement of international arbitration awards, foreign investors may feel insecure since the award is not binding. The broad court intervention is contrary to the spirit of the New York Convention which intend to prevent foreign arbitral awards from local court intervention. When intervention is permitted it is only on procedural matters not the merits of the case.⁶⁵ The local court authority is to determine whether enforcement of the award would violate their public policy. In doing so they should interpret public policy narrowly regardless there is an error on applying the law or fact.⁶⁶

2. The Trauma of the Dutch Colonialism Leads to the Emerging the Economic Nationalism

Economic nationalism is one reason why many Indonesians dislike the involvement of foreign investors in Indonesia. The principle of economic nationalism has been implemented in Indonesia for a long period.

⁶² *Ibid.*, p. 1158.

⁶³ Kantor, *Op.Cit.*, p. 1159.

⁶⁴ *Ibid.*

⁶⁵ Coulson, Robert, *Business Arbitration What You Need to Know*, (3rd ed. 1986), p. 30.

⁶⁶ McConaughay, Philip J., 1999, "The Risk and Virtues of Lawlessness: A "Second Look" at International Commercial Arbitration" *Northwestern University Law Review*, p. 468-470.

It was born because of the experience of the Dutch colonial system.⁶⁷

The goal of the economic nationalism is to empower the small entrepreneur to enable a fairer distribution of economic assets.⁶⁸ This is in accordance with most Indonesians's wish for the country's resources to be more distributed fairly. In doing so, the state has the authority to become involved in most of the aspects of economic activity, rather than relying on the market mechanism.⁶⁹ Therefore, government policy toward international trade has also been influenced by the "cultural-economic nationalism".⁷⁰

The liberal capitalism that has emerged in the name of globalization seems to conflict with the economic nationalism principle. The economic crisis in East Asia demonstrates that there should be more limits to "the mutuality of interest between international and local actors."⁷¹

It is likely that the refusal of the Indonesian parties to voluntarily perform an international arbitration award is a way to

resist foreign investor actions. This attitude becomes a trend since it is well supported by Indonesian courts.

3. National Interest

The next reason which is used to refuse the enforcement of international arbitration award is in the name of national interest. There is a requirement that the law must support the national interest.⁷² Therefore, every judicial decision shall be in accordance with the interest.

However, there is no clear definition about what is meant by national interest.⁷³ Even though the notion of national interest seems to prohibit foreign involvement in domestic affairs, it welcomes foreign donor countries to invest their funds in Indonesia.⁷⁴ It can be said that there is no consistency in Indonesian attitudes towards the notion of national interest. This may lead to further difficulties since the interest of certain group of people may be claimed as the national interest.⁷⁵ This is done in order to escape from

⁶⁷ David K. Linnan, 2000, "Bankruptcy Policy and Reform: Reconciling Efficiency and Economic Nationalism" in Lindsey, Timothy (ed), *Indonesia Bankruptcy, Law Reform & the Commercial Court*.

⁶⁸ Mohammad Sadli, Restoring Investor Confidence in Indonesia, Institute of Southeast Asian Studies, Singapore (2000) <<http://www.iscas.edu.sg/trends1220.pdf>> at 15 July 2004.

⁶⁹ Gary Dean, "Indonesia's Economic Development in Comparison to South Korea and Taiwan" <<http://www.okusi.net/garydean/works/IndEcDev.html>> at 15 July 2004.

⁷⁰ Nielsen, Richard P., 'Cultural-Economic Nationalism and International Trade Policy' (1979) 4(3) *The Academy of Management Review*, p. 449.

⁷¹ Pitman B. Potter, 2000, "Globalisation and Local Legal Culture, Dilemmas of China's Use of Liberal Ideals of Private Property Rights", *The Australian Journal of Asian Law*, p. 1.

⁷² Timothy Lindsey, 1999, "From Rule of Law to Law of the Rulers-to Reformation?" in Timothy Lindsey (ed), *Indonesia Law and Society*, p. 15.

⁷³ *Ibid.*, p. 16.

⁷⁴ *Ibid.*

⁷⁵ Linnan, *Op.Cit.*, p. 109.

their liability to foreign creditors.⁷⁶

The reason of national interest was also clearly evident in the Karaha case. Pertamina stated that the project had no benefit for Indonesian people.⁷⁷ It also argued that the Karaha had attacked Indonesia and its institutions in the way Karaha manipulated the facts.⁷⁸ For that reason, Pertamina insisted the court annul the arbitration award. It seems that the court considered the above measurements were in the nation's best interest, and this must be the top priority. Therefore the court decided to refuse the enforcement of the award. The negative impact of the use of national interest as reason is that it may decrease the 'legal certainty'.⁷⁹

4. Anti Foreign Investor Movement

There is a belief that the Asian monetary crisis is caused by foreign investors. The economic crisis has not only had a negative impact on the economies of Asian countries but has created some major political changes.⁸⁰ The International Monetary Fund (IMF) and other international donor agencies have been blamed for "undermining the region economically and acting in

an arrogant paternalistic manner."⁸¹ This assumption has led to an anti-foreign investor movement in Indonesia.

The fact that most of the electricity projects in which foreign investors are involved have local partners who are connected to the former President Soeharto, supports this assumption. The negative feeling towards the foreign investors then becomes more evident when the PLN's leaders stated that "they were coerced by the Soeharto administration to sign the contracts."⁸²

The foreign investors are said to be part of the corruption system in Indonesia since they were active in funding Indonesian government in the Soeharto period. Many Indonesian Non Governmental Organisations (NGO's) have argued that the foreign agencies have "forfeited the moral right to determine anti-corruption policy for Indonesia."⁸³ This condition has created an anti-western movement in Indonesia, which has caused problems for donor countries. The problems emerge when the donor countries work with Indonesian NGO's especially those which anti-corruption.⁸⁴ Past mistakes are not a reasonable reason to avoid cooperation with

⁷⁶ *Ibid.*

⁷⁷ Review-Oil & Gas: Pertamina Scores Legal Win, <http://laksamana.net/vnews.cfm?news_id=5612> at 13 May 2004.

⁷⁸ *Ibid.*

⁷⁹ Lindsey, *Op.Cit.*, p. 16.

⁸⁰ Kukreja, Sunil, States, National Interest and Asia's Currency Crisis: The Malaysian Case, <<http://www.ups.edu/ips/asiacrisis/malaysia.htm>> at 15 July 2004.

⁸¹ *Ibid.*

⁸² "Pertamina to abide by U.S Verdict in Contract Dispute", *The Jakarta Post*, 27 March 2004.

⁸³ Timothy Lindsey, 2002, "History Always repeats? Corruption, Culture, and Asian Values" in Tim Lindsey and Howard Dick (eds), *Corruption in Asia: Rethinking the Good Governance Paradigm*, p. 16.

⁸⁴ *Ibid.*

the foreign donor countries, however certain groups of people still try to avoid the involvement of the foreign investors.⁸⁵ From the foreign aid and agencies point of view, their involvement in the Soeharto era was inevitable.⁸⁶

It seems that negative feelings towards foreign investors have already influenced Indonesian courts as is evident in their refusal to enforce foreign arbitral awards. This can be categorized as an opposition to the right of foreign investors to employ arbitration.⁸⁷

5. Consequences of the Refusal of International Arbitral Awards

The Indonesian court involvement in the arbitration proceedings may create some consequences. In political contexts, the refusal to enforce the award may influence Indonesia's relationship with the country to which the foreign party comes from.⁸⁸ This is because the refusal can be categorised as a "denial of justice to a national of another country."⁸⁹ In the Karaha case, if Pertamina had not obeyed the award, it would have "deny the justice" and therefore

it is said that Pertamina was in contempt of the court.⁹⁰

Another consequence of the refusal, it may create economic problems such as the loss of foreign investment, since foreign investors no longer believe in the Indonesian legal system.⁹¹ The Karaha and the Himapura/Patuha arbitration proceedings lead to a lack of trust of foreign investors in international arbitration institutions to mitigate the risk of uncertain justice in Indonesia.⁹² The refusal to enforce the award will prevent "future infusions of wealth-creating capital and technology, and may backfire to inhibit international commercial and financial co-operation."⁹³

The Indonesian government has considered the danger that may occur in using its court to deny the foreign arbitration awards, even though it may give some benefits. For that reason, the government has considered to cover a US \$ 250 compensation payment to the Karaha on behalf of Pertamina.⁹⁴ However, it has not decided yet "who would pay the compensation and how the payments would be made."⁹⁵ This amount includes the

⁸⁵ *Ibid.*

⁸⁶ *Ibid.*, p. 16.

⁸⁷ Kantor, *Op.Cit.*, p. 1125.

⁸⁸ Redfern, A. and Hunter, M., *The Law and Practice of International Commercial Arbitration* (2nd ed, 1991), p. 45.

⁸⁹ Bishop, R. Doak, Dimitroff, Sashe D., and Miles, Craig S., 2001, "Strategic Options Available When Catastrophe Strikes the Major International Energy Project", *Texas International Law Journal*, p. 640.

⁹⁰ "Pertamina Harus Bayar Klaim KBC", *Kompas*, 26 July 2002.

⁹¹ Redfern and Hunter, *Loc.Cit.*, p. 45.

⁹² Kantor, *Op.Cit.*, p. 1125.

⁹³ *Ibid.*, p. 1178.

⁹⁴ "Indonesia government to Settle US \$ 250 Compensation to Karaha", *AFX European Focus*, 13 May 2004.

⁹⁵ "Pertamina to Abide by U.S. Verdict in Contract Dispute", *The Jakarta Post*, 27 March 2004.

exploration costs, interest and compensation for the loss of future profit.⁹⁶

A step has been taken to prevent such a case occurring in the future. The government is now drafting a regulation for investment in the country's power sector to ensure that, in the future, power projects are in accordance with the national electricity plan. The government will no longer provide a government guarantee for the investors.⁹⁷ Therefore, commercial risks will fully be borne by the investors. This policy has been made to prevent the government's involvement in commercial disputes which leads to huge claims.⁹⁸

F. New Reform

Indonesia enacted its first comprehensive arbitration law, namely Law Number 30 of 1999 concerning Arbitration and Alternative Dispute Resolution. This step was very timely since in this economic globalization, such a step is compulsory in the competitive global market place as a tool to attract foreign investment.⁹⁹ The new arbitration law has become very important, since national

law gives arbitration "its legally binding character".¹⁰⁰

The new Indonesian laws on arbitration consist of fundamental aspects which are consistent with the spirit of the New York Convention and the UNCITRAL model law. Firstly, the new law limits the court involvement only to a supporting role. The court is not allowed to interfere in settling disputes which have already been decided by arbitration.¹⁰¹ The Chief Judge of the District Court is the authorized appointing body.¹⁰² Secondly, the new law recognizes party autonomy. This principle has given the parties the freedom to determine the applicable procedural rules in their arbitration proceedings.¹⁰³ Thus, the parties have a broad scope to agree on the type of institutional rules that shall be "utilized in the conduct of the reference."¹⁰⁴ Thirdly, it recognizes the principle of severability in which the expiration and termination of the main contract does not affect the arbitration agreement.¹⁰⁵ Fourthly, the new law applies the principles of finality. The arbitration award is final and binding¹⁰⁶ except in certain circumstances.

⁹⁶ "Indonesian Charges Give New Twist to Long-Running Legal Case", *International Oil Daily*, 18 May 2004.

⁹⁷ "Government Prepares New Rules on Investment in Power Sector", *The Jakarta Post*, 24 April 2004.

⁹⁸ *Ibid.*

⁹⁹ Maniruzzaman, F.M., 2004, "Modernization of International Arbitration Law in the Age of Globalization: A Bangladesh Perspective", *International Company and Commercial Law Review*, p. 137.

¹⁰⁰ Park, William W., 1989, "National Law and Commercial Justice: Safeguarding Procedural Integrity in International Arbitration", *Tulane Law Review*, p. 656.

¹⁰¹ Article 11(2) Law No. 30 of 1999.

¹⁰² Article 13-15 Law No. 30 of 1999.

¹⁰³ Article 31(1) Law No. 30 of 1999.

¹⁰⁴ Article 34 Law No. 30 of 1999.

¹⁰⁵ Article 10(h) Law No. 30 of 1999.

¹⁰⁶ Article 60 Law No. 30 of 1999.

Even though the award is final and binding, the new law provides some grounds for setting aside the award. The grounds for setting aside an award are limited. The courts are not allowed to "re-examine the merits of the award."¹⁰⁷ An award can be set aside for three reasons: the award is to be based on forged documents; the opposing party has concealed vital documents; or the award is a result of fraud.¹⁰⁸

In addition, the new law departs from the UNCITRAL model law as it allows the arbitration tribunal broad discretion in choosing a procedure, where the parties have failed to agree.¹⁰⁹ For these reasons, it can be said that arbitration conducted under Indonesia's new law, theoretically should "result in references that are regulated in a manner which is consistent with most modern arbitration regimes."¹¹⁰

Even though the new Law came into effect few years ago, there has been no significant effect.¹¹¹ The new Law alone is not enough to create changes. In Indonesia, legislation is sometimes seen as mere 'window dressing'.¹¹² This is especially true when the legislation is promulgated due to the political and economic pressure from the major

foreign investor countries, or international financial agencies to reform the Law.¹¹³ This is what actually happens in Indonesia.

There is no sufficient provision regarding the enforcement of international arbitration award in the Indonesian arbitration law. The new law only gives criteria on what international arbitration can be enforced in Indonesia and procedure on how to enforce international arbitration award. However, it does not provide provision on how does the winning party can have their rights protected.

Therefore it is not surprising that the most crucial problem in international arbitration in Indonesia nowadays is the tendency of the Indonesian courts to refuse the enforcement of the awards, which do not favour to Indonesian parties. Enforcement is very important matter in arbitration because enforcement of an arbitral award is "a paramount interest in arbitration."¹¹⁴ The value of the arbitration proceedings depends on the certainty of the enforcement of the awards. If there is no guarantee of the enforcement of the awards, the arbitration process is "nothing more than a waste of time and money."¹¹⁵

¹⁰⁷ David Sandborg, 2002, "Arbitration Law Reform in Asia: Ready for the 21st Century?" Conference Paper, Conference on International Dispute Resolution, Arbitration Association of the Republic of China, Taipei, p. 10.

¹⁰⁸ Article 70 Law No. 30 of 1999.

¹⁰⁹ Article 31(2) Law No. 30 of 1999.

¹¹⁰ Sandborg, *Loc.Cit.*, p. 9.

¹¹¹ Taylor, *Op.Cit.*, p. 280.

¹¹² Hiscock, Mary. 2000. "Remodeling Asian Laws" in Tim Lindsey (ed), *Indonesia: Bankruptcy, Law Reform and the Commercial Court*, p. 28.

¹¹³ *Ibid.*

¹¹⁴ Budidjaja, *Op.Cit.*, p. 2.

¹¹⁵ *Ibid.*

When parties to a contract agree to arbitrate, the agreement must be capable of being enforced. Otherwise it will only serve as a statement of intention which merely persuasive without having legal effects.¹¹⁶ It seems that the court ignores the provision in the new law, and that the court is prohibited from being involved in the disputes which have already been decided by an arbitral tribunal.

Furthermore, in the Karaha case the Indonesian court seems to exceed their authority by annulling the arbitration award. This is because, according to the New York Convention the court which entitles to annul the award is the court of the country "in which or under the law of which, that award was made."¹¹⁷ Therefore, it is the Switzerland courts which have authority to annul the award since the proceeding was conducted in Geneva. The Indonesian court only has authority to grant or refuse the award to be enforced in Indonesia.¹¹⁸

Even though the Indonesian court had annulled the award that in favour to Pertamina, the decision is not capable to be enforced in Hong Kong, U.S or Singapore in where Pertamina has assets.¹¹⁹ This is because

there is a principle that court decisions from one country cannot be enforced in another country.

Indonesia differentiates between 'international arbitration conducted locally' and domestic arbitration.¹²⁰ Domestic arbitration in Indonesia is an arbitration which is conducted in Indonesia by using the Indonesian arbitration law.¹²¹ In fact, the term of domestic arbitration is not well understood by judges. In practice, having arbitration proceeding in Indonesia, using the Indonesian law, does not guarantee that the award will be considered as a domestic award.¹²² Judges often assume that because one of the parties is a foreign entity or the member of the tribunal is foreigner, therefore the award be categorised as international.

International arbitration should not be defined "in terms of the foreign nationality of one of the parties to arbitration, or the foreign juridical personality of a company as a party to arbitration, but should be defined in terms of "the parties places of business in different states."¹²³ The latter approach has been found in the New York Convention, as well as in the UNCITRAL model law. This approach is broader, therefore it should be

¹¹⁶ Redfern and Hunter, *Op. Cit.*, p. 5.

¹¹⁷ Kantor, *Op. Cit.*, p. 1166.

¹¹⁸ Juwana, Hikmahanto, in 'Ketua BANI: Putusan PN Jakarta Sudah Benar' <<http://www.hukumonline.com/detail.asp?id=6332&cl=Berita>> at 17 July 2004.

¹¹⁹ Juwana, Hikmahanto, in 'Ketua BANI: Putusan PN Jakarta Sudah Benar' <<http://www.hukumonline.com/detail.asp?id=6332&cl=Berita>> at 17 July 2004.

¹²⁰ Taylor, *Op. Cit.*, p. 288.

¹²¹ Green, *Op. Cit.*, p. 295.

¹²² Pryles as quoted by Green, *Ibid.*, p. 297.

¹²³ Maniruzzaman, *Op. Cit.*, p. 136.

preferred.¹²⁴ It is important to narrow the definition of foreign arbitration as that suggested, in order to get the award recognized as domestic and thus enforceable by the Indonesian court.¹²⁵

It seems that Indonesia has not totally reformed its law regarding international arbitration. The reason for Indonesian hesitation to reform is "the insufficient attention paid to the economics of Indonesia business, now as well as in the past."¹²⁶ In addition, it is possibly because the idea of reform mainly comes from the donor countries or foreign aid agencies while in most Indonesian point of view those agencies participated in deteriorating Indonesian economy.¹²⁷ It seems that it is an effort to avoid the possibility of foreign control over Indonesian economy.

G. Recommendation

There are some steps for foreign investors to consider. The first step is to make sure that the arbitration clause is well drafted. In practice, it can be said that many arbitration clauses in international projects are drafted without a proper understanding of the potential limits of arbitrability.¹²⁸ The drafters need to use appropriate language to make

sure that it describes the broad scope of the potential disputes to be submitted to arbitration. It is very important to avoid claims that the transactions are unarbitrable in the host country which would lead to unenforceable arbitration awards. In Indonesia, the scope of arbitrability is only in regard to disputes in "the commercial sector concerning rights, which in the law and regulations have the force of law and are fully controlled by the parties in dispute".¹²⁹

There is still another difficulty, even if the contract drafters have already included broad provisions, drafting skill alone cannot prevent the Indonesian court from determining the court from holding that fraud or that corruption allegations exist in the contract. As the Indonesian courts held in the Karaha case and the Paiton case, those projects are obtained through corrupt means therefore, they are not arbitrable in Indonesian law. Since the case being non-arbitrable, the award cannot be enforced.¹³⁰ From the investor's interest, the Indonesian court opportunity to claim that such a dispute is unarbitrable due to the allegations of corruption making the contract more uncertain.¹³¹ The possibility of refusal to give exequatur (approval) by the local court, therefore,

¹²⁴ *Ibid.*

¹²⁵ Green, *Op.Cit.*, p. 301.

¹²⁶ Paul H. Brietzke, 2000, "Governance and Companies Law in Indonesia" *Australian Journal of Asian Law*, p. 196.

¹²⁷ Lindsey, *Op.Cit.*, p. 16.

¹²⁸ Kantor, *Op.Cit.*, p. 1132-1133.

¹²⁹ Law No. 30 of 1999 Article 5.

¹³⁰ Kantor, above n. 54, p. 1175.

¹³¹ *Ibid.*, pp. 1132-1133.

should be carefully considered by contract drafters.¹³²

Based on this definition, it is better to hold the arbitration proceedings under Indonesian law in Indonesia rather than overseas. This choice represents the best of few alternatives that foreign investors may consider. By locating arbitration proceedings in Indonesia, the award will be treated as a local arbitration award, and therefore can be enforced more easily than a foreign arbitration award.¹³³

Another alternative is by using BANI as the institutional arbitration. There is an assumption that by using BANI the award will be treated as a domestic award and therefore it will be enforceable in Indonesia. Moreover, BANI has reputable sufficient number of arbitrators both domestic and international from various expertises.¹³⁴

However, using BANI can also create other problems, since its rules are very simple and therefore these do not cover as many aspects as other arbitration rules cover. These difficulties can be overcome by "supplementation of its rules in the contractual arbitration provision; or by expressly providing that other specified rules for example UNCITRAL or the New York Convention

are to be used."¹³⁵

It is undeniable that foreign lawyers lack awareness of BANI's rules and services. Their limited knowledge of BANI appears to be caused by insufficient information which is given to them rather than from their direct experience.¹³⁶

The most important consideration when enforcement takes place is the location of the assets belonging to the losing party.¹³⁷ In order to minimize the risk of non-recognition of the international arbitration award, the foreign investors should ask the local partners to place assets outside the host country. An independent foreign arbitral proceeding has maximum benefit if important assets from the losing party are located outside the jurisdiction of the host state.¹³⁸ Therefore, when the losing party does not obey the award voluntarily, and when the local court refuses to enforce the award, the winning party still has an opportunity to enforce the award in another country, in which the losing party has assets. A court can only assist within the enforcement of an award against assets which are located in the area within the jurisdiction of that court.¹³⁹

Generally speaking, the enforceability of arbitral awards is easier and less problem-

¹³² Kantor, above, n. 54, p. 1175.

¹³³ Taylor, above n. 5, p. 288.

¹³⁴ Hukum Online, "Ketua BANI: Banyak Klausula Arbitrase Tidak Berfungsi" <<http://www.hukumonline.com/detail.asp?id=6089&cl=Berita>> at 17 July 2004.

¹³⁵ Green, *Op.Cit.*, p. 301.

¹³⁶ *Ibid.*

¹³⁷ Budidjaja, *Op.Cit.*, p. 3.

¹³⁸ Kantor, *Op.Cit.*, p. 1125.

¹³⁹ Budidjaja, *Loc.Cit.*, p. 3.

atic than that of the international court judgment.¹⁴⁰ However, in some countries like Indonesia, enforcement of an arbitral award requires additional time and money.¹⁴¹ This is because the enforcement cannot take place until the Central Jakarta District court gives an exequatur to execute the award.¹⁴²

It is also useful to include in the arbitration clause a requirement that none of the arbitrators can be a citizen of the country of any parties.¹⁴³ The aim of this requirement is to maintain the independence of the arbitrators. The independence of the arbitrators plays an important role since it is "a pillar of the arbitral system."¹⁴⁴

Usually an international arbitrator will avoid handling a case in which he or she is of the same nationality as one of the parties.¹⁴⁵ This is common if there is a single arbitrator. If there is tribunal which consists of three arbitrators or more, the chairman will not have the same nationality as one of the parties, even though each of the party may appoint arbitrators who have the same na-

tionality as the parties.¹⁴⁶

Often when the parties are government agencies, they feel obliged to appoint as an arbitrator a person from their own country. The problem with this is that it is usually done without having regard to the experience of the person, their language ability and capability to persuade the chairman.¹⁴⁷ This also happened in the Karaha case in which the Pertamina appointed Mr Priyatna as an arbitrator. The Karaha case is a disincentive for further foreign investment in Indonesia.¹⁴⁸

It is important for international arbitration today that both government and private entities are consistent in using "universal concepts, methods and legal standard" in the of arbitrations process.¹⁴⁹ This is crucial to maintain the certainty of the enforcement of the international arbitration awards around the world.

For Indonesia, it is urgent to develop "modern commercial law contracts" which provide a guarantee of certainty in order to

¹⁴⁰ Pryles, Michael, 1996, "Assessing Dispute Resolution Procedures", *The American Review of International Arbitration*, p. 272.

¹⁴¹ Tran, *Op. Cit.*, p. 367.

¹⁴² *Ibid.*

¹⁴³ *Ibid.*, p. 1177.

¹⁴⁴ Bernini, G., 1999, "Report on Neutrality, Impartiality and Independence in *Varady et. all.*", *International Commercial Arbitration*, p. 272.

¹⁴⁵ Pryles, *Loc. Cit.*, p. 280.

¹⁴⁶ *Ibid.*

¹⁴⁷ Lawrence W. Newman, 1992, "A Practitioner's Observations on the Resolution of International Commercial Disputes", *American Review of International Arbitration*, p. 88.

¹⁴⁸ Investment Climate 2001, < <http://www.aicccusa.org/investment9620climate.pdf> > at 19 July 2004.

¹⁴⁹ Vratislav Pechota, 1992, "The Future of the Law Governing the Arbitral Process" *American Review of International Arbitration*, p. 25.

attract foreign investment.¹⁵⁰ This can be done by providing a better legal environment to resolve commercial disputes.¹⁵¹ As Indonesia has nullified international arbitration awards, foreign investors have hesitated to invest their funds. While it is arguable that the Indonesian economy can survive without foreign investment, it seems that giving the foreign investors legal certainty would be desirable.¹⁵²

H. Conclusion

The Indonesian judicial system does not give a fair and impartial protection for disputes which involve foreign investors. This often happens when the party is the Indonesian government or its legal entities. The lack of legal certainty for the enforcement of international contracts and differential treatment of domestic versus foreign companies are major concerns.

International arbitration may not provide the best solutions to resolve commercial disputes, therefore foreign investors should be very cautious in relying on.¹⁵³ The record of enforcement of foreign arbitral awards in Indonesia is weak. In practice, foreign companies have many difficulties to enforce arbitration awards or getting the judicial system to give exequatur of the awards.

International commercial arbitration in Indonesia has not reached its ultimate utility. Even though Indonesia has enacted a new law on Arbitration, there is no significant change. This is because the law reform is not accompanied by changes in the behaviour of the people involved in the judicial system. This situation became worse since in regard to the enforcement. The New York Convention depends greatly on the local court for its implementation.¹⁵⁴

From the two formal mechanisms for resolving a dispute between foreign and Indonesian parties to a private agreement, domestic arbitration in Indonesia appears to have more advantages than foreign arbitration. This is because domestic arbitration has less problematic procedure when it comes to the stage of enforcement.¹⁵⁵ Therefore, it is necessary to take Indonesian domestic arbitration into account.

In order to minimize the risk of non-recognition of international arbitration awards in Indonesia, the arbitration clause must be drafted in which it describes the broad scope of the disputes. Furthermore, it is better to consider BANI as the institutional arbitration in order to have the award be considered as domestic award.

¹⁵⁰ Taylor, *Op.Cit.*, p. 287.

¹⁵¹ *Ibid.*

¹⁵² Stuart G. Gross, 2003, "Student Note: Inordinate Chill: BITS, Non-NAFTA Mits, and Host-State Regulatory Freedom-an Indonesian Case Study" *Michigan Journal of International Law*, p. 959.

¹⁵³ Kantor, *Op.Cit.*, p. 1126.

¹⁵⁴ Pechota, *Op.Cit.*, p. 27.

¹⁵⁵ Green, *Op.Cit.*, p. 301.

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